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Article Background

This essay and the comment below were originally published in the January, 2000 newsletter.

Chris Horan Essays

One of the enjoyable parts of my job is I get to write a short essay for this newsletter. To make the essays most useful to you, I try to address critical investment strategy issues in what I hope is a thought provoking way.

Please feel comfortable calling me to discuss the issues or to suggest a future topic.

This issue's essay discusses the phenomenal dominance of the market indexes by technology stocks. It's on the back cover.

Bad Breadth

Last year about 40 stocks contributed almost all of the 38% return in the S&P 500, an index of 500 US stocks, according to Barron's, a financial newspaper.

The term "breadth" refers to the number of stocks going up or down in an overall market. A market is said to "advance broadly" when say 75% of stocks go up. A "narrow market" is where only a few stocks move.

Generally speaking, a broad market move is more reliable than a narrow market; a narrow market tends to be fragile and not healthy. So only 40 stocks moving up out of 500 is "bad breadth."

This year is worse. The Nasdaq Index tracks more than 4,850 US stocks, including a broad range of technology stocks. The index was up almost 120% in the 12 months to November 30, 1999. Only 65 stocks out of the 4,850 or fewer than 2%, have contributed to 99% of that gain, according to an article in the Wall Street Journal. Very bad breadth.

How can that happen? The answer is that the indexes are calculated in such a way that the companies with the biggest market value have the most impact. So a few very large companies can drive the index.

This is exactly what's been happening. Investors are pouring their money into technology and other growth stocks, driving their values into orbit. Microsoft, for example, currently has a market value approaching the GNP of Canada, according to The Economist, a business newspaper.

The picture in Canada is similar. BCE and Nortel account for 20% of the TSE 300. Nortel has tripled in the last year and has carried the TSE index with it.

Technology stocks now account for 24% of the total market value of the S&P 500 Index, according to Barron's, up from 7% in 1990. No other group comes close. The last time any group of stocks accounted for such a large percentage of the S&P 500 was when oil stocks were 27% of the index in 1980. But that was when we were sure that oil was going to $50 a barrel. (Oil stocks are now back at 6% of the total market.)

What's my advice? Above all, don't go chasing the technology growth stocks, as powerfully attractive as they are. Pouring your money into last year's screaming winner is rarely wise and often foolish. Be sure to understand the danger in buying something when the future looks rosy. If you want the big technology growth stocks in your portfolio, use a technology fund and keep it to 5 or 10% of your portfolio. Don't be afraid to own high quality stocks that are out of favour. They have a way of doing well. There are many bargains hidden in those 450 stocks that aren't in orbit.